RECEIVED
AUG 14 2 48 PM '00
POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

OCA-RT-2
Docket No. R2000-1

REBUTTAL TESTIMONY

OF

EDWIN A. ROSENBERG

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

AUGUST 14, 2000

TABLE OF CONTENTS

Page

UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2000) Docket No. R2000-1

DIRECT TESTIMONY OF EDWIN A. ROSENBERG

I. STATEMENT OF QUALIFICATIONS

My name is Edwin A. Rosenberg. I am an economist, and I have been employed since 1991 by The National Regulatory Research Institute (henceforth, NRRI), which is located at The Ohio State University in Columbus, Ohio. The National Association of Regulatory Utility Commissioners (NARUC) established the NRRI in 1976, and the NRRI's primary mission is to provide research and advice to members of NARUC, such as the Postal Rate Commission. A more complete statement of my qualifications is contained in OCA-T-3, which was submitted earlier in this proceeding.

II. PURPOSE AND SCOPE OF TESTIMONY

The purpose of my testimony is to reconsider the conclusion of my previous testimony in this proceeding (OCA-T-3). That conclusion was that the contingency provision of one percent of total estimated costs, which was allowed in Docket No. R97-1, should be continued in this Docket. I have reconsidered my conclusion in light of the updated test-year revenue and expense estimates contained in the testimony of USPS witness Richard Patelunas (USPS-ST-44).

III. SUMMARY OF THE UPDATED TEST-YEAR REVENUE AND EXPENSE ESTIMATES

The original estimates of test-year revenues, expenses, and the revenue requirement were contained in USPS witness Tayman's testimony.[1] In his supplemental testimony, Mr. Patelunas used actual revenue and expense figures for FY 1999 and updated estimates or forecasts of various factors to develop updated estimates of revenues and expenses both for FY 2000 and for the test year, FY 2001. The updated test-year revenue and expense estimates reflect a number of changes, including the use of actual 1999 revenue and expenses as the basis for the FY 2000 and test-year estimates and the use of updated, and generally higher, forecasts or estimates of various inflation factors for 2000 and 2001. As a result of the update, estimated after-rates, test-year revenues and expenses increased by $252.8 million and $451.5 million, respectively.

[1] USPS-T-9.

In addition, the updated revenue requirement estimates were adjusted to reflect the fact that the Postal Service now projects a net loss in FY 2000 rather than the net income it had originally projected. The swing from a projected FY 2000 net income of $65.6 million[2] to a projected FY 2000 loss of $325.5 million[3] leads to an increase in the allowance for recovery of prior years' losses from $268.3 million to $311.7 million.

The original and updated estimates of test-year revenues and expenses are shown in Table 1, below. In Table 1, I also show the effect of using a one percent provision for contingencies instead of the 2.5% provision requested by the Postal Service in this proceeding. Please note that the revenues are as requested by the Postal Service and that the contingency amounts are treated as expense items in Table 1.[4]

---

2 USPS Exhibit 9L.

3 USPS Exhibit ST-44E.

4 While Table 1 displays the contingency as if it were an expense amount, this is a misleading approach. It is inappropriate to include the requested contingency provision in a calculation of net income or, for that matter, the shortfall from the annual or cumulative equity restoration targets (Exhibit USPS ST-44G). Including the contingency provision in those calculations may lead to a distorted – and much more negative – view. The contingency provision is a part of the revenue requirement. It is not, however, an actual cost that the Postal Service incurs. It is not, therefore, a cost that must be recovered. Rather, the contingency provision is an amount added to the sum of estimated test-year costs and the allowance for recovery of prior years' losses to determine a revenue requirement that offers the Postal Service a reasonable chance to attain its long-run breakeven goal.

Table 1
Test-Year Revenues, Revenue Requirement and Net Surplus or (Deficiency)
($ 000,000)

	Original[5]		Updated[6]	
	Before Rates	After Rates	Before Rates	After Rates
Total Revenues	66,328.4	69,116.8	66,579.0	69,369.6
Total Cost Segments	68,046.6	67,190.6	68,357.5	67,642.1
Estimated Net Income (Loss)	(1,718.2)	1,926.2	(1,778.5)	1,727.5
Contingency Provision (Using One Percent of Total Cost Segments)	680.5	671.9	683.6	676.4
Recovery of Prior Years' Losses	268.3	268.3	311.7	311.7
Total Revenue Requirement Assuming a 2.5% Contingency Provision	70,016.0	69,138.7	70,378.1	69,644.9
Total Revenue Requirement Assuming a One Percent Contingency Provision	68,995.4	68,130.8	69,352.8	68,630.2
Net Surplus (Deficiency) Assuming a 2.5 Percent Contingency Provision.	(3,887.8)	(21.8)	(3,799.1)	(275.3)
Net Surplus (Deficiency) Assuming a One Percent Contingency Provision	(2,667.0)	986.0	(2,773.8)	739.4

5 See USPS-T-9, Table 15 and USPS Exhibit 9A.

6 See USPS Exhibit ST-44A. Please note that the Postal Service filed several sets of errata on August 11, 2000, concerning the "net surplus (deficiency)" figure. For example, in a revised response to Presiding Officer's Information Request No. 14, Item 2(b) and (e) Errata, witness Patelunas states: "Had the $200 million Field Reserve been incorporated into the update as it should have been, certain of the Operations cost reductions, as well as the Grand Total All Programs, would decrease. The overall Test Year After Rates impact would be to increase the deficiency shown on Exhibit USPS-ST44A from –$275.3 million to approximately –$475.3 million." I have not reflected this erratum in my Table 1 because witness Patelunas has not yet revised his testimony, exhibits, nor the underlying library references.

IV. THE UPDATED EXPENSE ESTIMATES MAY OVERSTATE THE REVENUE REQUIREMENT AND THE REVENUE DEFICIENCY

A. The Use of Conservative Estimates of Cost Savings Resulting from the Breakthrough Productivity Initiative May Result in an Overestimate of Actual Test-Year Costs, Revenue Requirement, and Revenue Deficiency

The Postal Service is putting its multi-year Breakthrough Productivity Initiative into effect.[7] This Initiative includes a number of factors, including reengineering work processes, employing technology to achieve savings, and reducing the size of the workforce. Estimates or targets of the cost savings resulting from this Initiative have been in the range of $700 million to $1 billion annually over four years. However, $200 million of projected or targeted cost reductions were classified as "Field Reserve" and were not reflected in the updated test-year cost reductions.[8] Although the Postal Service does not view the exclusion of $200 million of projected or targeted cost reductions as being a form of contingency provision,[9] the exclusion of that $200 million in targeted cost reduction increases the estimated test-year revenue requirement and revenue deficiency by $205 million (using the Postal Service's requested 2.5%

[7] See "Breaking Through to a New Golden Age of Mail," Remarks of William J. Henderson, Postmaster General/CEO United States Postal Service, at the National Postal Forum, Nashville, Tennessee, March 20, 2000," United States Postal Service, *Postal News*, (undated); Statement of William J. Henderson, Postmaster General and Chief Executive Officer, United States Postal Service, before the Subcommittee on Treasury, Postal Service, and General Government Committee on Appropriations, U.S. House of Representatives, April 4, 2000; "Postal Service to Cut 700 Jobs, Reduce Costs by $1 Billion Annually for Four Years," *PostCom Bulletin*, June 30, 2000; and Statement of William J. Henderson, Postmaster General and Chief Executive Officer, United States Postal Service, before the Subcommittee on International Security, Proliferation, and Federal Services, Governmental Affairs Committee, U.S. Senate, July 13, 2000.

[8] See Mr. Patelunas's response to OCA/USPS-ST44-11 at Tr. 35/16652. Please see footnote 6 concerning errata filed on August 11, 2000.

[9] See the Postal Service's institutional response to OCA/USPS-ST44-11(e).

contingency provision). Using a one percent contingency provision, the estimated test-year revenue requirement and revenue deficiency are increased by $202 million. Thus, to the extent that the Postal Service is able to achieve its cost-reduction target in FY 2001, the estimated costs, revenue requirement, and revenue deficiency are overstated.

B. The Shift from ECI Minus One Percent to ECI to Estimate Test-Year Wage Increases May Tend to Result in an Overestimate of Actual Test-Year Costs, Revenue Requirement, and Revenue Deficiency

The Postal Service had previously based its estimates of bargaining-unit wage increases on the rate of growth of the Employment Cost Index (ECI) minus one percent. In his updates, Mr. Patelunas deviated from this approach and used the projected rate of increase in the ECI.[10] This is not an insignificant shift, as wage costs are a major part of total Postal Service costs, and the increase in test-year costs resulting from this change is estimated by OCA witness Pamela Thompson to be approximately $230 to $245 million.[11]

To the extent that the Postal Service is able to hold wage increases below the rate of growth in the ECI during the test year, labor cost figures contained in the updated test-year expense estimates will tend to be overstated. Moreover, as I noted in the above discussion of the exclusion of the "Field Reserve" from estimated cost reductions, to the extent that estimated costs are overstated, the estimated revenue requirement and the estimated revenue deficiency will be overstated by that amount

[10] See Mr. Patelunas's response to AAP/USPS-ST44-5 and Tr. 35/16796-800.

[11] See OCA-RT-3, p. 15.

plus whatever contingency provision is allowed on the overestimate. Although Mr. Patelunas offered no explanation for the shift to ECI from ECI - 1, one observer has commented that, "A cynic might suggest that ECI - 1 was abandoned to give the USPS a $230 million cushion."[12]

C. No Attempt Was Made To Validate the Updated Rollforward Estimates of Revenues and Expenses for FY 2000 Against Actual Realized Revenues and Expenses for FY 2000 to Date

The estimate of test-year revenues and expenses is based on a rollforward of estimated FY 2000 revenues and expenses, which are based on a rollforward of actual FY 1999 revenues and expenses. Estimates based on actual FY 1999 data are generally preferable to estimates based on estimated FY 1999 data. However, since Financial and Operating Statements for 10 of the 13 accounting periods in PFY 2000 were available by the time the updates were filed, it might have been useful to use data derived from PFY 2000 to date to check or validate the rollforward estimates. Mr. Patelunas notes that the actual partial-year PFY 2000 data was used only on a limited basis in developing the updated rollforward estimates.[13]

There will be some differences between the PFY 2000 results and the FY 2000 results due to slightly different time periods.[14] Nevertheless, the PFY and FY results are likely to be fairly similar. For example, the AP13 year-to-date net income figures for

---

[12] See "Short Takes," *Business Mailers Review*, August 7, 2000.

[13] See Mr. Patelunas's response to OCA/USPS-ST-44-6, Tr. 35/16644-46.

[14] PFY 2000 began on September 11, 1999; FY 2000 began October 1, 1999.

the 1998 and 1999 PFYs were \$586.5 million and \$348.8 million, respectively,[15] while FY 1998 and 1999 net incomes were \$550.3 million and \$363.4 million, respectively. Although seasonality in volumes, revenues, and expenses must be considered when using partial-year data, the PFY 2000 results to date might have been used to estimate PFY results and thereby to assess the accuracy and validity of the rollforward estimates.

Through PFY 2000 AP11, the Postal Service had a year-to-date net income of \$436.0 million. Assuming that PFY 2000 and FY 2000 net incomes are similar in magnitude, in order to realize Mr. Patelunas's FY 2000 estimated net loss of \$325.5, the Postal Service would have to lose approximately \$761.5 million over the two final accounting periods of PFY 2000. For this to happen, the Postal Service's net losses for PFY 2000 AP 12 and AP 13 would have to be \$132.5 million more than called for in the PFY 2000 Operational Plan. This could happen, but I note that the combined net losses for AP 10 and AP 11 of PFY 2000 were only \$500,000 less than called for in the PFY 2000 Operational Plan. Moreover, if Postal Service managers act successfully on the recent service-wide directive to control expenses and limit discretionary spending,[16] the actual loss may end up being less than the \$325.5 million shown in the updated rollforward estimates.

In fact, there is some indication that the estimated loss might not materialize at all. Postal Service Acting Chief Financial Officer Strasser has recently been quoted as

---

15 See USPS Financial and Operating Statements, Accounting Period 13, PFY 1999, p. 1.

16 See *Postal Bulletin* 22029, July 27, 2000, p. 3.

standing by the original projections for a positive FY 2000 net income of $66 million.[17] Moreover, he stated that, "Concerted management action, with a surge in revenue in Accounting Periods 12 and 13 (better than 3%), still make it possible to end the year with a positive net income."[18]

To the extent that the actual net loss for FY 2000 turns out to be less than $325.5 million, or actual net income is positive, the recovery of the prior years' losses component of the revenue requirement will be overstated if an estimated loss is included in the RPYL calculation, as will the revenue deficiency.

D. The Use of More Recent Forecasts of Revenues, Expenses, and Inflation Factors Support a Less Generous Contingency Provision

Mr. Patelunas has noted that the revised cost level forecasts, which are based on more recent forecasts by DRI, are likely to be more accurate than those contained in the original filing.[19] This makes sense: the closer the Postal Service's estimates are to the forecasted period, the more accurate its forecasts are likely to be. The use of more recent, and therefore presumably more accurate, forecasts of the economic environment during the test year lowers the level of uncertainty and supports a smaller contingency provision than would otherwise be the case.

OCA witness Thompson provides a table showing the extent of the updating of indices used in the revised cost-level forecasts. Table V of OCA-RT-3 notes that

---

[17] See "Short Takes," *Business Mailers Review*, August 7, 2000.

[18] Ibid.

[19] See Mr. Patelunas's response to OCA/USPS-ST-44-28, Tr. 35/16670.

indices in most cases are current as of April-May 2000. The use of more current indices is very significant in considering the appropriate level of the contingency provision to be recommended.

E. Although Higher Than in the Past, Fuel Prices Are Not Likely To Continue Their Recent Rapid Upward Trajectory

In the updated inflation indices,[20] the component showing the largest difference is the index for gas and oil. The original filing reflected FY 2000 and FY 2001 increases in that index of 17.66% and –2.11%, respectively. The revised filing reflects FY 2000 and FY 2001 increases in that index of 30.69% and 6.13%, respectively. The difference between the original and revised filings is +13.03% for FY 2000 and +8.24% for FY 2001.

Gasoline and oil prices are volatile, responding to changes in such factors as OPEC policy, the behavior of individual OPEC members, and weather fluctuations. Gasoline prices sometimes take sudden upturns, but the rate of increase often moderates or turns negative after a major rise.

DRI's July 2000 forecast estimates the rate of increase in gas and oil prices for 2000 and 2001 to be 28.1% and –1.2%, respectively.[21] The U.S. Department of Energy's Energy Information Administration (EIA) forecasts that the average retail price of regular unleaded gasoline will increase by 22.9% in 2000 and decline by 11.0% in 2001. Similarly, the EIA forecasts that the retail price of No. 2 diesel fuel will increase

---

[20] See USPS Exhibit ST-44AB.

[21] See DRI, Standard & Poor's, *The U.S. Economy 2000/7*, July 2000, p. 29.

by 26.8% in 2000 and decline by 9.2% in 2001 and that the retail price of No. 2 heating oil will increase by 38.6% in 2000 and decline by 12.3% in 2001.[22]

The Postal Service may point to fuel price volatility as the sort of uncertainty that justifies the requested 2.5 percent contingency provision. Use of the May 2000 DRI figures, however, would overstate these test year expenses compared to use of the more recent July 2000 forecast. Available data also indicates that fuel prices frequently fall back after a sharp increase. Figure 1 shows the time path of the annual average retail price of regular unleaded gasoline from 1976 to 2000. The 2000 estimate is based on the average of the monthly prices through July.[23] Figure 2 shows the monthly time path of the average retail price of regular unleaded gasoline from January 1998 to August 2000.[24]

---

22 See EIA, *Short-Term Energy Outlook*, August 2000, Table 4. Accessed August 8, 2000 at http://www.eia.doe.gov/emeu/steo/pub/4tab.html.

23 Data from EIA's *Monthly Energy Review*, Table 9.4. Accessed August 8, 2000 at http://www.eia.doe.gov/pub/energy.overview/monthly.energy/mer9-4).

24 July 2000 value estimated from EIA weekly data. The August 2000 value is the weekly value for August 7, 2000. Data accessed August 8, 2000 at http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/weekly_retail_gasoline_prices/current/txt/rtlgas.txt.

Figure 1
Regular Unleaded Gasoline Retail Price
(annual average 1976 - 2000e)

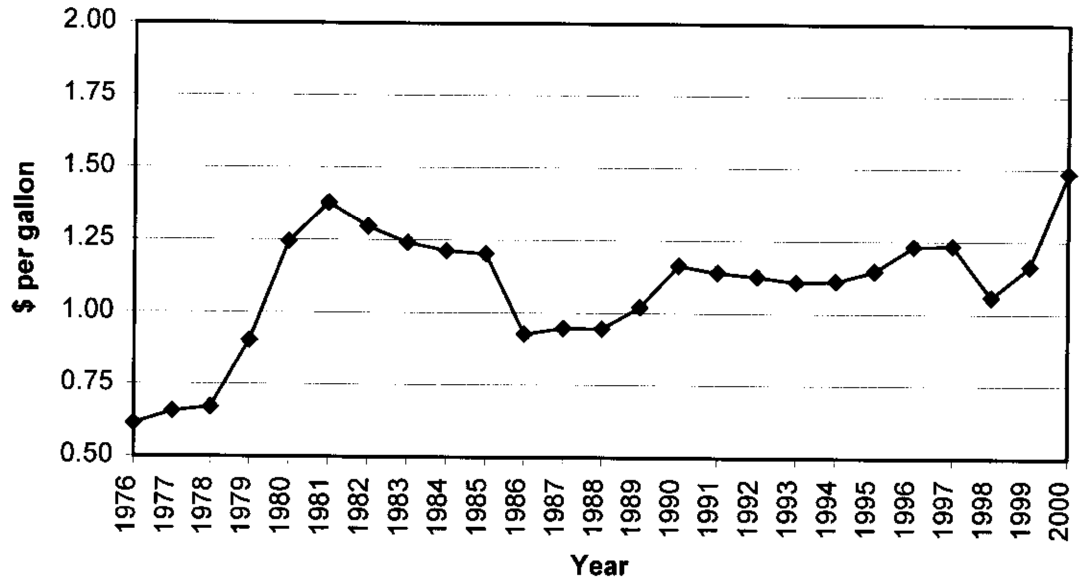
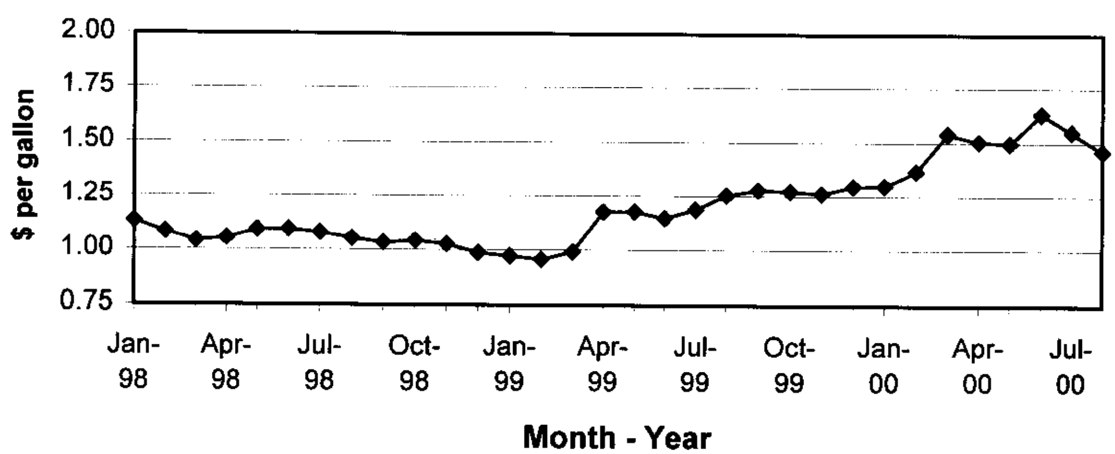


Figure 2
Monthly Average Retail Price of Regular Unleaded Gasoline
(January 1998 - August 2000e)



V. CONCLUSION

Using the estimated test-year costs presented by Mr. Patelunas, which, as noted above, may tend to be overstated, a one percent contingency provision allows an estimated revenue surplus of $739.4 million. If costs are lower than estimated, or if FY 2000 net loss is less than estimated (or a positive income is realized), the surplus will be even greater. Based on the foregoing discussion, and the fact that more recent forecasts of test-year inflation factors have been used to update the test-year cost estimates, I maintain my previous recommendation that a contingency provision of one percent of total estimated costs be used in this proceeding.